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FLO.N - Q2 2023 Flowers Foods Inc Earnings Call

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OVERVIEW:

Company Summary

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A. Ryals McMullian *Flowers Foods, Inc. - President, CEO & Chairman of Board*

J. T. Rieck *Flowers Foods, Inc. - Executive VP of Finance & IR*

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Connor Rattigan *Consumer Edge Research, LLC - Research Analyst*

James Ronald Salera *Stephens Inc., Research Division - Analyst*

Mitchell Brad Pinheiro *Sturdivant & Co., Inc., Research Division - Research Analyst*

William Bates Chappell *Truist Securities, Inc., Research Division - MD*

PRESENTATION

Operator

Good day, and thank you for standing by, and welcome to the Flowers Foods Second Quarter 2023 Results Conference Call. Please be advised that today's event is being recorded. I would now like to hand the conference over to your speaker today, J.T. Rieck, Executive Vice President of Finance and Investor Relations. Please go ahead, sir.

J. T. Rieck - *Flowers Foods, Inc. - Executive VP of Finance & IR*

Thank you, Norma, and good morning, everyone. I hope you all have the opportunity to review our earnings release, listen to our prepared remarks and view the slide presentation that were all posted yesterday evening on our Investor Relations website. After today's Q&A session, we will also post an audio replay of this call. Please note that in this Q&A session, we may make forward-looking statements about the company's performance.

Although we believe these statements to be reasonable, they are subject to risks and uncertainties that could cause actual results to differ materially. In addition to what you hear in these remarks, important factors relating to Flowers Foods business are fully detailed in our SEC filings. We will also provide non-GAAP financial measures for which disclosures and reconciliations are provided in the earnings release and at the end of the slide presentation on our website. Joining me today are Ryals McMullian, Chairman, CEO and President; and Steve Kinsey, our CFO. Ryals, I'll turn it over to you.

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Chairman of Board*

Great. Thanks, J.T. Good morning, everybody. Thanks for joining the call today. I'm very pleased with the strong quarterly results. Our performance recovered after a slow start to the year, helped by the competitive strength of our leading brands despite strategic pricing initiatives designed to mitigate inflationary pressures. Volume trends in our branded retail business did improve, and that may be an early indication that consumer demand is migrating back to pre-inflationary levels.

That top-line strength translated into improved margins and earnings, which is reflected in our updated 2023 guidance. Private label products gained share, but that growth appears to be moderating. So we remain confident that the trend towards premiumization driven by our investments in innovation and marketing will win out over the longer term. I'm excited about our prospects, and I've really never been more confident in our ability to grow shareholder value over time. So in normal with that, we are ready to open up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question will come from the line of Bill Chappell with Truist Securities.

William Bates Chappell - *Truist Securities, Inc., Research Division - MD*

I guess, can we start a little bit more commentary on Canyon. I didn't fully understand kind of what happened to have the deterioration of, I guess, market share and margins over the past few months and just trying to understand how that improves going forward. It seem like Canyon's had a pretty strong trajectory for the past few years, and I just didn't know if that is more of a sign of we're hitting a plateau or if there's something else that I don't fully understand.

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Chairman of Board*

Yes, sure. I'd be happy to. I would describe it as temporary, Bill. I mean a lot of it has to do with capacity. It's in some ways a good problem to have because, as you know, Canyon has been on a really nice trajectory, but we got a little bit tight. We've had to do some things to restructure Canyon's portfolio and made some more investments at the Canyon Bakery to help free up additional capacity.

So we've got that solved. That's coming online in the second half, and we've got plans to reinvigorate the growth. There is a little bit of channel shifts as well that's happening that's not picked up by the syndicated data. So what you're seeing is a little different than reality. But again, I put that in the temporary category. We'll get that back on track. Canyon's got a -- still got a great future ahead of it.

William Bates Chappell - *Truist Securities, Inc., Research Division - MD*

And then this is the second or third time you put in the -- your commentary, kind of a thought of moving into tangential categories through M&A. And at the same point, I think you've talked about rolling out Dave's Killer Bread bars sometime in '24 and didn't know if those kind of coupled if you'd like to have greater expertise in the snack bar or tangential category before expanding that kind of nationwide? Or any kind of update on how that's going would be great.

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Chairman of Board*

The rollout is going -- we're going really well. So those initial 3 SKUs of bars, Bill are in the middle of a nationwide rollout right now. So I think we noted in the prerecorded commentary that we're in about 12,000 stores. We will be in more than 13,000 by year-end, and we'll actually slightly be slightly ahead of our own expectations for that rollout.

For 2024, there are 3 new SKUs of bars coming out that are higher protein-based. They are the amped-up protein bars, really great product. They've been in test market for a while. They've done extremely well in test market. And I think most promising is they're proving to be incremental to the original 3 SKUs. So I think we're touching a different consumer segment with that higher protein offering. And then of course, behind that, we've got the snack bites. Those are still in tests, those will be coming a little bit later and then a whole pipeline of innovation even behind that. So we're really excited about what we're building from an innovation standpoint with Dave's.

William Bates Chappell - *Truist Securities, Inc., Research Division - MD*

And I guess with -- from an M&A standpoint, does that make the bars category more attractive from a -- getting out of just Street Bread as you're building expertise and building kind of a national following behind a brand?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Chairman of Board*

Yes, it could. I mean it would definitely depend on the brand and what that brand brings to the consumer. I mean, it is a crowded category. So we want to be careful that we're investing in the right segments of that category. Yes, there are definitely opportunities out there we'd be interested in.

Operator

Our next question comes from the line of Mitchell Pinheiro with Sturdivant & Company.

Mitchell Brad Pinheiro - *Sturdivant & Co., Inc., Research Division - Research Analyst*

I guess a couple of questions here. First, you spoke a lot, you spent time in the -- in your script about private label and you're seeing sort of improved trends, but you still have -- you still vary on -- you're just not sure where it's going. And I'm curious, are you seeing the positive or a trend back to brands even into here in August. And what you might be looking for as signs of either of movement in either direction.

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Chairman of Board*

Yes, sure. Great question. So a couple of things there. Private label still gained share in the quarter. But I think it's important to note that, that growth is slowing. And this was -- towards the end of the quarter was the lowest that we've seen in terms of gains for private label this year. So that's definitely on a good trend. The other thing to remember, and we've talked about this all year.

This is the private label phenomenon is playing out more in mass than it is in grocery, and actually it lost share in grocery. Continues to gain in mass. We've talked about there's been a little bit of channel shift as consumers seek bargains in mass, club, dollar, that sort of thing. I do think also that it's important to note that the private label share gains are generally confined to that loaf category, the traditional products. In other words, those with the least differentiation. Private label loss share in virtually every other category where you tend to see more differentiation, so especially breakfast sandwich buns and rolls, that sort of thing. So the trend towards premiumization is definitely still there.

Clearly, consumers are still looking for bargains, but that trend is headed in the right direction from our standpoint as we look to build our branded business. Mitch, I'd also point to -- and we did mention this in the prerecorded commentary. Dave's had a great quarter, up 7% in units in the syndicated data. That's a really, really good sign. Particularly given its premium positioning. If you recall, about 20% of Dave's Killer Bread shoppers are low-income households. It was a surprising number to me when I first found out. But that's where we were really starting to lose a lot of the unit volume. And in fact, earlier in the year, Dave's units had turned negative.

Well, now those low-income shoppers are coming back to the brand and helping us achieve that nice unit growth in the second quarter and were positive for the year. We did also gain some penetration and higher income households that help. So just all of these factors put together give us some confidence that consumer health is improving. Now we did caution everyone that we're not ready to call the play yet. We'd like to see that trend continue well into the third quarter before we conclude that it's here to stay, but definitely some really nice early signs.

Mitchell Brad Pinheiro - *Sturdivant & Co., Inc., Research Division - Research Analyst*

And then, looking at your food service in the other category, I mean, how much pricing -- is there still pricing to go there? Number one. Number two, are you seeing any pushback on pricing so far? And as these volumes come down, how does that have an impact on your gross margins?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Chairman of Board*

Sure. So as far as pricing goes, we got in the pricing that we needed for the year. Now there is some of it on the contractual business that will continue to trickle in, but I think it's fair to say most of its own. As far as resistance goes, broadly speaking, everybody understands the inflationary environment. So we -- again, we were able to get through all the pricing that we wanted.

In terms of volume, remember a lot of the volume declines. First of all, overall, the volume declines are largely made up of food service and cake volume declines. And then most of that is intentional. So as we rationalize some of that lower-margin business that we've been talking about, that certainly plays into it. Same thing on the cake side, just getting out of some of the cheaper business, focusing more on the branded business. Obviously, that's having an effect on volumes.

I think sequentially, for cake, you should see that improve. It did improve this quarter quite markedly because we're really starting to lap some of the heavy SKU rat that we did last year. And then finally, in terms of food service, we did have some disruptions in the quarter from one of our cold storage suppliers that definitely impacted volume performance in the quarter.

Mitchell Brad Pinheiro - *Sturdivant & Co., Inc., Research Division - Research Analyst*

And then just last question. So when it comes to -- you talked about, I was interested in the -- you've moved some of your sales, your -- I guess, the bakery function away from the sales leadership and more to the supply chain leadership and you're seeing positive benefits on both ends, better efficiency in the bakery. And also, you pointed out how you're pleased with how the sales sort of have improved. And I'm just curious how that -- you have a lot of national customers, how much influence the local sales leadership has at each bakery and whether is there also a reduction in force at all as it relates to the sales just having more sales out there -- more salespeople out there.

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Chairman of Board*

Well, I'll answer your last question first. No, not from a material standpoint. Obviously, there's always a little bit of attrition in turnover. But I think the more important pieces of your questions are, yes, it does have an effect at the local level. Yes. A lot of national accounts now, grocers have consolidated. We all know that. But the area sales director can have a major impact at the local store level, helping to sell in that additional display, for example.

Those types of executional elements are critical. And I would point to that reorganization as one of the reasons we performed so well in the quarter. As you know, this is the big summer bun season. We had our best bun season ever. We achieved our highest bun share in the quarter. I think those are all proof points that the organizational restructure is working. It's Mitch, it's really a matter of focus having our sales folks be able to focus only on sales, what they do best and then similarly on the supply chain side, having that expertise solely focused on running those bakeries as efficiently as possible. And to your point, we've seen improvements on both fronts.

Operator

One moment for our next question, please. And next question comes from the line of Connor Rattigan with Consumer Edge.

Connor Rattigan - *Consumer Edge Research, LLC - Research Analyst*

Congrats on a great quarter. Yes. So just kind of wanted to follow-up on some of Mitch's questions there. So you noted private label share gains somewhat moderating in the quarter and sort of confine them to the more, I guess, traditional load segment. And sort of with those share -- and I guess, just trying to get a fact. I'm just trying to get a sense just how much of a factor is maybe mix shift -- shifting maybe more towards the bond segment or I guess these more differentiated segments in the summer month? And I guess maybe is there any concern that consumers are maybe just temporarily moving to different segments of the category where private label is under shared?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Chairman of Board*

Yes. Actually, we've been seeing that trend for some time. If you go back quite a few quarters, I think we talked about that pretty heavily that even within the category, we were seeing shifts more towards specialty premium, more towards breads, buns and rolls, more towards breakfast items, all of which tend to have a higher level of differentiation and are certainly more premium products as well.

So for example, our Nature's Own perfectly crafted Brioche buns have done extremely well. That's a differentiated item from just a standard white but, the Dave's Killer Bread, Bagels, English muffins, et cetera, even the buns with Dave's have done really well as well as that broader specialty premium category. So I think it's a trend we've been seeing for a while, somewhat disrupted by the inflationary environment because, obviously, we talked a lot about trade down and households economizing. But I think over the longer pull, I think that trend remains in place.

One of the things that we're focused on here is how can we bring more differentiation to that traditional loaf category. It is still our largest segment. So it's very important. From performance from a cash flow standpoint, all of it. So what can we do to further differentiate those mainline Nature's Own items? Is it from a quality standpoint, a packaging standpoint, a different flavors, et cetera. So that's something that we're focused on here.

Unidentified Analyst

Perfect. And then just back at SKU rationalization a little bit as well. So there was a volume headwind again in the quarter, obviously. And just I guess I was just wondering, was the headwind driven mostly by comparison from prior rationalizations? Or were there more SKUs actually limited during the quarter? And I mean, I know you mentioned that you expected to lessen in the second half. But I guess, just trying to get a sense for if there are a lot more skewed potentially on the chopping block or if you're pretty much all finished?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Chairman of Board*

I'm going to break that into 2 pieces because on the cake side, we're largely done. And I think we said at the beginning of the year, you'll see those volume declines start to moderate as we move to the back half of the year, and you -- we saw that even in the second quarter. So that's on the cake side. I mean, obviously, there's always continued SKU rationalization, but the bulk of it that we've been doing over the last couple of years, we're sort of through that.

On the food service side, it's a little bit different because we still have some of that lower-margin business that we'll be rationalizing over time. And it's not all going to come at once. Some of it is under contract and that affects the timing we did exit some more late in the quarter. I wouldn't say that that's heavily responsible for the volume decline in the second quarter. That's more the previous rational license we did, the disruption with the coal storage operator, et cetera, was more responsible for that. So on the food service side, to sum up, I would say we're not done yet. But it's not like it's going to come all at once. It will be spread out over a number of years.

And it's really about -- we intend to stay in food service. We like the food service business. It's really about exiting that lower-margin business, margining up in food service and even more importantly, shifting that capacity and production to branded retail.

Operator

Our question comes from the line of Jim Salera with Stephens.

James Ronald Salera - *Stephens Inc., Research Division - Analyst*

You talked in the prepared remarks about the stabilization on the branded side, do you feel like there's anything you can do in the near term to maybe juice that a little bit, whether it's from an advertising standpoint or a promotional standpoint? Do you feel that there's a way you kind of help it along to get it on the brand is going back in the right direction and gaining share?

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Chairman of Board*

Yes, good question. I'm glad somebody asked about promotions. I was hoping we get that. Yes. So to answer your question, yes, we are doing things to use your words. So if you look at SG&A marketing was up in the quarter, I think that's something you can continue to expect to see from us. We're very committed to our marketing efforts to support these brands. I think that's always important. From a promotional standpoint, we did promote a little bit more in the quarter. I wouldn't call it out as anything terribly significant.

I think overall, in the category, promotions were up a little bit, but still well below historic or even pre-pandemic levels. So no significant movements there. The interesting bit that we're seeing is that even when we do promote, the incremental units aren't terribly attractive. So we have to be very selective about when we do promotions to ensure we're getting a good return on those promotions. And there are some good ones out there that they had to be sure.

But I think what that tells you is a little something else about the consumer, right? If you're putting an item on promotion and you're really not getting that lift that you normally see, what it tells me is the shopper is still not -- they're only buying what they need. So it's another indication that consumers are still trying to economize in the household. So we'll see how those trends continue.

But I think the takeaway is the category has not gotten terribly promotional, at least not yet. And to the extent that there are promotions, we're really not seeing that incremental lift that you might have seen in the past.

James Ronald Salera - *Stephens Inc., Research Division - Analyst*

And then maybe to drill down on kind of the balance between promotions versus marketing because you mentioned step up on the marketing side. Could you give a sense for which one of those drives consumer engagement, especially with the less differentiated branded products. Is it better to have a low priced [I'm assuming] this number of \$0.05 less? Or is it better to have 5% more airtime or visibility? So it has the brand top of mind for consumer.

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Chairman of Board*

Yes. I think they're both important. They may serve slightly different purposes. I mean promotions can be very effective in driving trial, for example. So if you think about our bar launch, obviously, we're doing ads and promotions for the bars because we're trying to bring new consumers to that. Certainly, marketing can do that for you as well. But almost look at marketing as much about retention as it is acquisition.

And so it's really -- the combination of the 2 are really important depending on what you're trying to drive. In a more commoditized category, yes, promotions are probably at least historically a little bit more effective despite what I just got finished talking about. But I think the most important thing that we can do within our portfolio of brands is continue to drive differentiation and then drive consumers to that with a combination of promotions and marketing.

Operator

I am currently showing no further questions at this time. I would now like to turn the conference back to Ryals McMullian, Chairman, Chief Executive Officer and President, for closing remarks.

A. Ryals McMullian - *Flowers Foods, Inc. - President, CEO & Chairman of Board*

Great. Thank you, Norma. I just want to thank everybody for taking time today and joining us for questions. We really appreciate your interest in our company. And as always, we look forward to speaking with you next quarter. Everybody, take care.

Operator

Thank you for your participation. You may now disconnect. Everyone, have a wonderful day.

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